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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975.

No. 75-780

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO,
Petitioner,

vs.

MOLLIE NUSSBACHER,
Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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INTRODUCTION.

The brief filed by respondent in opposition to the petition for certiorari in this case attempts to distract attention from the fact that it has been the consistent policy of this Court, dating from the decision in *Hawes* v. *Oakland*, 104 U. S. 450 (1881), to its most recent pertinent decision in *Swanson* v. *Traer*, 354 U. S. 114 (1957), to uphold the discretion of the board of directors to pass upon the wisdom and expedience of prosecuting corporate litigation. That policy has rested upon the conviction that to allow individual stockholders and their attorneys to make corporations their involuntary clients and embroil them in improvident litigation would waste the resources of the federal courts, impair the democratically constituted authority within the corporation, and conflict with the

best interests of the corporation as perceived by those who are in the best position to evaluate those interests—the corporate board and its legal advisors. In 1957, this Court found it necessary to correct the Seventh Circuit for failing to enforce this fundamental policy in the case of *Swanson* v. *Traer*, 354 U. S. 114. There, it was necessary to bring to the attention of the Seventh Circuit the "classical" precedent of *Hawes* v. *Oakland*, 104 U. S. 450, and its Supreme Court progeny. In the present case, as in *Swanson* v. *Traer*, it is necessary once again to remind the Seventh Circuit that the decisions of this Court, upholding the authority of corporate directors to direct the affairs of their companies, are controlling precedents which may not be disregarded or ignored by the Seventh Circuit.

I. The Erroneous Decision of the Seventh Circuit Does Not Involve a Narrow Factual Interpretation, but Rather a Fundamental Misinterpretation of the Purpose and Function of Rule 23.1. The Seventh Circuit's Erosion of the Standing Requirement of Rule 23.1 Will Greatly Increase the Volume of Vexatious and Groundless Derivative Litigation in the Federal District Courts.

In her brief in opposition to the petition for certiorari in this case, the stockholder-respondent attempts to characterize the decision of the Seventh Circuit below as a narrow factual decision, establishing no important legal principle, and having no significance as legal precedent. She argues that the decision is based on a "unique factual situation" which is "unlikely to recur." That, however, is plainly incorrect. The Seventh Circuit has held that mere opposition by the directors to the maintenance of suit is sufficient to vest the stockholder with authority to maintain derivative litigation, because resort to the directors would be "fruitless or futile" in the circumstances. Moreover, the Seventh Circuit has implied that mere prior "participation" by the directors in the business transaction which the stockholder would contest gives rise to a presumption that the directors are

incapable of exercising business judgment. *See*, Petition for Certiorari, pages 7-8. If this holding is allowed to stand, the floodgates will be opened to improvident derivative litigation on the broadest scale. In every case where the stockholder proposes litigation which is truly groundless and vexatious, the stockholder will be able to argue (as here) that the directors are "opposed" to the suit, and would "refuse" to institute suit if demand were made upon them. If that is an excuse for bypassing the directors, then unfounded derivative litigation will be openly encouraged and facilitated. Moreover, if it is sufficient to allege that some of the directors had previously "participated in" or "approved" the business transaction which the stockholder would make the basis for suit against a third party, then resort to the board will be excused in nearly every instance, for it is, of course, the function and duty of the directors to "participate in" and "approve" all of the major business transactions of the corporation. To treat this performance of duty by the directors as an excuse for stripping them of authority over corporate litigation would be to virtually abolish the doctrine of business judgment in the field of stockholder litigation and reduce Rule 23.1 to a meaningless provision.

Nor is it possible to argue that the disagreement between the District Court and the Seventh Circuit in this case is a minor factual disagreement. The facts relevant to this motion are not in doubt. The point of disagreement in the courts below was the *legal standard to be applied to those facts*. The District Court held that, absent some allegation of bias, conflict of interest, or inability to exercise business judgment, the stockholder could not wrest control of corporate litigation from its rightful possessors. *See, Appendix to Petition for Certiorari*, pages A6 through A14. The Seventh Circuit held, in contrast, that, given the stated "opposition" of the directors to the proposed litigation,* and their prior participation in or approval of the busi-

* Contrary to the impression given by the stockholder-respondent in her brief in opposition to the instant petition for certiorari, it was

(Continued on next page)

ness transaction involved, it was appropriate to bypass them and plunge ahead. *See, Appendix to Petition for Certiorari,* pages A21 through A24.

The legal question decided by the Seventh Circuit (erroneously, we believe), far from being unimportant, is a question vested with the most significant public policy ramifications. To argue that this case presents an inconsequential factual controversy is an absurdity. The question before this Court is whether the restrictions of Rule 23.1 should be enforced for the purpose of controlling vexatious stockholder litigation, or whether stockholders may make major corporations their involuntary clients and embroil them (over the objection of an unbiased board of directors) in protracted commercial litigation to the detriment of the corporate interest. If the holding of the Seventh Circuit is allowed to stand, it is clear that nuisance litigation will be greatly encouraged and the resources of the federal courts needlessly wasted. Indeed, petitioner submits that it is difficult to conceive of a legal question with greater significance to the administration of derivative litigation in the federal district courts.

II. By Arguing That Director Opposition to the Stockholder's Litigation Proposal Makes Recourse to the Directors "Futile," the Stockholder Has Placed in Clear Perspective the Erroneous Rule of Standing to Sue Adopted by the Court Below.

On page 10 of her brief in opposition to the petition for certiorari, the stockholder-respondent argues that the decision below is correct because "a complainant need not allege a demand on directors when it is clearly shown that if such a demand had been made it would have met with refusal. . . ." That argument, however, totally misconceives the principle of standing contained in Rule 23.1. Under Rule 23.1, a derivative complaint is insufficient on its face if it fails to establish that the directors of the corporation are incapable of exercising unbiased business judgment.* The stockholder does *not* have standing to prosecute derivative litigation where the directors disapprove such litigation unless the stockholder alleges a sufficient ground for stripping them of their legal authority to determine corporate policy.

Accordingly, resort to the board is not "futile," "vain," or "useless" simply because the directors disagree with the stockholder and disapprove proposed litigation which they know to be groundless. Indeed, in such instance, the formal refusal of the board to authorize suit is an expression of business judgment which it is the very purpose of Rule 23.1 to preserve. "Futility" exists only in cases where the directors are subject to domination by persons having an interest antagonistic to the corporate interest, or are subject to a genuine conflict of interest which causes them to place their own interests ahead of those of the corporation, or are otherwise incapable of exercising unbiased business judgment.** *The decisions of this Court establish plainly that mere opposition to the stockholder's litigation proposal is not equivalent to "futility," and does not excuse demand. See e.g., Swanson* v. *Traer,* 354 U. S. 114, 115-117 (1957), where, despite the fact that the directors were "defin-

petitioner Continental Bank (not the stockholder) which apprised the District Court and the Seventh Circuit of the opposition of the directors to this litigation. In conformity with the long line of Supreme Court decisions on this point, petitioner Continental Bank maintained that the good faith opposition of the directors was a *bar* to further derivative proceedings.

* In such instance, there is no excuse for bypassing the board or substituting the judgment of the stockholder for the board's considered business judgment. Unless the board is shown to be subject to a conflict of interest or otherwise incompetent to do its duty, the litigation proposal must be presented to the board. And, as shown in our petition for certiorari, pages 9-18, the board is empowered to conclusively determine whether or not suit should be commenced.

** Domination of the members of the board, depriving them of objective business judgment, is the most common ground for a finding of "futility." "Futility," however, is not lightly to be inferred. *See, Wathen* v. *Jackson Oil Co.,* 235 U. S. 635, 640 (1915): ". . . nor does it appear that, by reason of antagonistic control of the corporation, such a request would be futile."

itely and distinctly opposed to the institution of [the] litigation," it was still necessary to inquire whether the stockholder had pleaded facts showing that his complaint was "exceptional" and that he was entitled to "dispute the management and take the reins of corporate litigation in his own hands." Pursuant to the mandate of this Court, the Court of Appeals in *Swanson* subsequently determined that the stockholder had no standing to assume control of corporate litigation, holding squarely that the Board's "refusal" to act did not "clear the way" for derivative litigation. 249 F. 2d 858-859. Similarly, in *United Copper Co.* v. *Amal. Copper Co.*, 244 U. S. 261, 263-264 (1917), this Court considered whether a derivative suit could be brought when the corporation "refuses to institute the suit itself." Justice Brandeis, writing for the Court, answered that question in the negative, stating clearly that "[w]hether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors . . ." *Accord*: *Hawes* v. *Oakland*, 104 U. S. 450 (1881), holding that a derivative complaint must be dismissed despite allegations that the "directors and trustees have wholly declined to take any proceedings whatever in the premises . . ." (*Id.* at 451) because "[t]he directors are better able to act understandingly on this subject than a stockholder residing in New York" (*Id.* at 462). Thus, the decisions of this Court confirm that mere opposition by the board of directors does *not* constitute futility or authorize the stockholder to "take the reins of corporate litigation in his own hands." The contrary conclusion of the Court below establishes that it has gravely erred in its interpretation of the standing requirement of Rule 23.1.*

* The stockholder-respondent argues in favor of this erroneous conclusion by misdescribing the *purpose* of Rule 23.1. *See*, respondent's brief in opposition to the petition for certiorari, page 9: "The purpose of demand is to induce remedial action on the part of management and demand will be excused where it is apparent that if made, it would be refused." The conclusion is wrong because the premise is wrong. The purpose of demand is *not* to induce remedial action.

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III. As the District Court Correctly Held in This Case, the Argument of the Stockholder That the Directors Are "Personally Liable" (and Thus Are Incapable of Exercising Business Judgment) Is Groundless as a Matter of Law. Boiler-Plate Charges of Personal Liability, Having No Foundation in Law, Are No Justification for Stripping the Directors of Control Over Corporate Litigation.

After extensive briefing on the question, the District Court concluded that the stockholder's argument that the directors were "personally liable" as "participants" in or "aiders and abettors" of an illegal loan (and thus were unable to exercise good faith business judgment), was groundless as a matter of law. *See, Appendix to Petition for Certiorari*, pages A8-A9, A14. The Seventh Circuit did not disagree, attaching "no significance" to arguments concerning such personal liability. *See, Id.* at A23. The reason for rejecting this boiler-plate charge of "personal liability" is obvious. *First*, the stockholder has never served these directors with process, indeed, has specifically directed the marshal *not* to serve them. They have not been served with process to date (either in this case or in the companion case in New York), even though the stockholder originally commenced litigation in 1971. Clearly, the stockholder is not in good faith pursuing these directors as defendants, but rather has named them in her complaint as a strategy to evade the demand requirement of Rule 23.1. That tactic, however, has no validity:

The purpose of demand is to refer the final decision as to whether remedial action should be taken to the good faith business judgment of the board. And, of course, the final decision of the board may be to *decline* remedial action altogether as improvident or groundless: "The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. . . . And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess, irrespective of other considerations." *Corbus* v. *Gold Mining Co.*, 187 U. S. 455, 463 (1903).

> "This complaint has a bold and expansive thrust. It attempts to solve the problem of the specificity of demand under Rule 23.1, in the case of mutual funds by a simple device. It simply sues *everybody*, including the *unaffiliated* directors. The plaintiff then 'bootstraps' the argument, by asserting with an air of injured innocence, that since she is suing the *unaffiliated* directors as well, how can she be expected to go to them for relief? . . . . . [However], it is not for the plaintiff herself to build a wall around the unaffiliated director of a mutual fund, and then tell him he cannot jump over it. In short, merely naming the directors as defendants does not establish that a demand would have been futile." *Phillips* v. *Bradford*, CCH Fed. Sec. L. Rept., ¶ 94,508, at pages 95,783-95,784 (S. D. N. Y. 1974) ('73-'74 Trans. Bind.).

Second, as the District Court correctly held, the "personal liability" speculation is conclusively groundless in this case because the law is clear that, in 1968, at the time of the supposed "loan" herein, the credit regulations imposed no responsibilities or liabilities upon borrowers or their officers. The credit regulations imposed responsibilities and liabilities solely upon creditors. *See, e.g.*, Loss, *Securities Regulation*, Vol. V. (1969), page 3304, confirming that "it is not illegal for a customer to buy on credit illegally extended." *See also, Pearlstein* v. *Scudder & German*, 429 F. 2d 1136, 1141 (2nd Cir. 1970), holding unequivocally that: "the federally imposed margin requirements forbid a [creditor] to extend undue credit but do not forbid customers from accepting such credit." *See also, U. S.* v. *Van de Carr*, 343 F. Supp. 993, 1014 (C. D. Cal. 1972), citing a host of authorities holding that the onus of compliance with the credit regulations is solely upon the creditor, and that " '[n]o duties or restrictions were imposed by the Act and the Regulation upon the investor-customer.' "*

* In an effort to resist this line of authority, the stockholder-respondent refers to a *complaint* in which a contrary theory is espoused. *See*, the footnote on page 13 of the brief in opposition to the instant petition for certiorari. However, the mere existence of a

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In sum, the District Court was wholly correct in rejecting the speculation of the stockholder that the directors are so fearful of "personal liability" that they must be presumed incapable of exercising business judgment.*

IV. The Authorities Cited by the Stockholder in Her Brief in Opposition to the Petition for Certiorari Confirm That the Decision of the Seventh Circuit Below Is in Conflict with the Controlling Decisions of This Court.

The stockholder-respondent, in an attempt to show that there is some ambiguity in the law which favors the decision of the Seventh Circuit, has only made more conspicuous the conflict which exists between the Seventh Circuit decision and the decisions of this Court. It is ironic that the stockholder cites *Ashwander* v. *Valley Authority*, 297 U. S. 288 (1936), since the concurring opinion of Justices Brandeis, Cardozo, Stone and Roberts in that case is a landmark statement of the legal principles controlling here:**

> "Courts may not interfere with the management of the corporation, unless there is bad faith, disregard of the relative rights of its members, or other action seriously threatening their property rights. This rule applies whether the mistake is due to error of fact or of law, or merely to bad business judgment. It applies, among other things, where the mistake alleged is the refusal to assert a seem-

complaint filed by counsel for a private litigant is not legal precedent for the proposition that officers of a borrower corporation are personally liable for obtaining excessively generous credit. The judicial authorities considering the point are contrary, and virtually uncontradicted.

* *See, also, Wathen* v. *Jackson Oil Co.*, 235 U. S. 635, 638-641 (1915), holding that the stockholder's grounds for wresting control from the directors were "palpably inadequate," despite charges that the directors were acting out of personal "fear" of "enormous penalties" and legal sanctions which deprived them of business judgment.

** The Court's opinion in *Ashwander* was joined in by four Justices. Four Justices joined in the concurrence here quoted. *See*, 297 U. S. at 356. Justice McReynolds filed a dissenting opinion.

> ingly clear cause of action, or the compromise of it. . . . If a stockholder could compel the officers to enforce every legal right, courts, instead of chosen officers, would be the arbiters of the corporation's fate." *Id.* at 343.

Surowitz v. *Hilton Hotels Corp.*, 383 U. S. 363, 371 (1966), stresses (as we have attempted to do in our petition for certiorari) that the purpose of Rule 23.1* is to "discourage 'strike suits' by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them." This Court there noted that the chief purpose of the derivative suit was to protect shareholders "from the designing schemes and wiles of insiders who are willing to betray their company's interests in order to enrich themselves"—*self-dealing activities which are in no way alleged here.*

The case of *Del. & Hud. Co.* v. *Albany & Susquehanna*, 213 U. S. 435 (1909), confirms that the "demand" requirement is "intended to secure the Federal courts from imposition upon their jurisdiction and recognizes the right of the corporate directory to corporate control." (*Id.* at 446.) Only in "emergencies," where the "antagonism between the directory and the corporate interest may be unmistakable," is the demand requirement inapplicable. (*Id.* at 447.)**

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* The Court in *Surowitz* discussed the purpose of Rule 23(b), the predecessor of the current Rule 23.1.

** This Court found such an emergency to exist in the *Albany & Susquehanna* case because the board was dominated and controlled by outsiders having an unmistakably antagonistic interest. *See Id.*, at 450-451. The lower court decisions relied upon by the stockholder-respondent in the instant case also fit that description. *Those cases are virtually irrelevant here because there are no charges in the instant complaint of "control" or "domination" of the board by persons adverse in interest. The stockholder-respondent has not and could not claim that Continental Bank controls the board of Leasco Corporation.* In *Cathedral Estates* v. *Taft Realty Corp.*, 228 F. 2d 85, 88 (2nd Cir. 1955), demand was excused because the real defendants in the action controlled the board. *Accord: In Re Penn Central Securities Litigation*, 367 F. Supp. 1158, 1163-1165 (E. D. Pa. 1973); *Pioche Mines Consolidated, Inc.* v. *Dolman*, 333 F. 2d

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The case of *Smith* v. *Sperling*, 354 U. S. 91 (1957), did not pass upon the demand requirement, but was concerned solely with the proper alignment of parties:

> "Whether [this] is a proper case for assertion by a stockholder of that cause of action is not the question here. Such was the problem involved in *Hawes* v. *Oakland*, 104 U.S. 450. . . . We are concerned only with a question of federal diversity jurisdiction." *Id.* at 94-95.*

Accordingly, it is plain that, to the extent that the Supreme Court cases cited by the stockholder-respondent have any relevance here, they strongly confirm the correctness of the decision of the District Court in this case, and establish that the Seventh Circuit decision below is in conflict with the decisions of this Court.**

257, 264-265 (9th Cir. 1964); *deHaas* v. *Empire Petroleum Co.*, 286 F. Supp. 809, 814-815 (D. Colo. 1968); *Cohen* v. *Industrial Finance Corp.*, 44 F. Supp. 491, 494-495 (S. D. N. Y. 1942); *Liboff* v. *Wolfson*, 437 F. 2d 121, 122 (5th Cir. 1971) (per curiam); *Jannes* v. *Microwave Communications, Inc.*, CCH Fed. Sec. L. Rept., ¶ 93,966, at page 93,866 (N. D. Ill. 1972) (1973 Trans. Bind.).

* *See also, In Re Kauffman Mutual Fund Actions*, 479 F. 2d 257, 265, footnote 5 (1st Cir. 1973): "The sole question there raised [in *Smith* v. *Sperling*], commencing with a 30-page opinion of the district court, 117 F. Supp. 781, was whether the corporation, as an indispensable party, was to be realigned as a party . . ." In the case of *Swanson* v. *Traer*, 354 U. S. 114 (1957), however, decided the same day *Smith* v. *Sperling* was decided, this Court *did* consider the demand question. The conclusions of this Court in *Swanson* v. *Traer* are discussed on pages 5-6 above, and on pages 14-15 of the Petition for Certiorari in this case.

** Petitioner also submits that the efforts of the stockholder-respondent to argue that *In Re Kauffman Mutual Fund Actions*, 479 F. 2d 257 (1st Cir. 1973), is *not* in conflict with the decision of the Seventh Circuit herein are wholly unpersuasive. The stockholder argues that *Kauffman* did not consider the situation where the directors had "participated in or approved of the acts of which complaint was made." *See*, brief in opposition to the petition for certiorari, pages 18-19. That argument, however, is completely refuted by reviewing the First Circuit's opinion at 479 F. 2d 265-267 (section three of the First Circuit's opinion). Moreover, it should be noted that on June 4, 1973, the First Circuit denied rehearing in

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V. The Stockholder Has Misdescribed the Attitude of Leasco's Board of Directors Toward This Litigation. The Directors Disapprove This Litigation Because They Believe It to Be Based Upon a Distortion of the Facts, to Be Injurious to the Corporate Interest, and to Be Inconsistent with Business Ethics.

The stockholder-respondent has attempted to cast doubt upon the position of the Leasco Directors with regard to this litigation. However, the affidavit and resolution which Leasco's directors provided for petitioner Continental Bank, to be used in support of the dismissal motion in this case, set forth their views with perfect clarity. *See, Appendix to Petition for Certiorari,* pages A1-A5. The Leasco Board regards the proposed derivative litigation to be based upon a distortion of the facts, because the transaction which the stockholder would characterize as an undermargined "loan" was nothing of the sort. In fact, the transaction in question was a bona fide *sale* of stock, as the Leasco Directors have stated in their affidavit and corporate resolution, as Leasco has stated in its answer to the derivative complaint, and as Continental Bank has stated in its answer to the derivative complaint.

Because the stockholder's theory that Continental Bank made a "loan" to Leasco Corporation upon excessively generous terms —and this is the substance of her pretended grievance—rests entirely on a misrepresentation of the facts, the Directors of Leasco Corporation believe the instant litigation to be inconsistent with the standards of good faith and honesty which they

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the *Kauffman* case in an unpublished decision, and refused to permit the stockholder to introduce affidavits purporting to elaborate upon director participation in the challenged transactions, pointing to "section three of the court's opinion" as a ground for its refusal.

observe in their dealings with other members of the business community. They wholly refuse to seek to procure an unfair financial advantage at the expense of Continental Bank through the misrepresentation of fact which is the basis for this stockholder's proposed derivative suit. These and other objections to the instant litigation, set forth in the affidavit cited immediately above, place this litigation in proper context and make emphatic the importance of reaffirming the requirements of Rule 23.1 which have hitherto controlled vexatious stockholder litigation of this very kind.

CONCLUSION.

The Leasco directors have expressed cogent business reasons for opposing the instant derivative litigation. The derivative complaint alleges no domination of the directors, no conflict of interest, and no legally valid ground for concluding that the directors are incapable of exercising business judgment. The District Court properly applied the decisions of this Court, and the decision of the First Circuit in *In Re Kauffman Mutual Fund Actions,* 479 F. 2d 257, in dismissing the derivative complaint. Consistent with those decisions, the District Court rejected the sham "futility" arguments of the stockholder raised to evade the requirements of Rule 23.1. In this case, the rhetoric of "futility" is mere boiler-plate which it is the obligation of the District Court to penetrate to prevent an imposition upon its equitable jurisdiction, and to secure to the business corporation here involved the protection from harassment contemplated by Rule 23.1.

Here, as in *Swanson* v. *Traer,* 354 U. S. 114 (1957), it is necessary once again to instruct the Seventh Circuit that the precedents of this Court are binding upon it and may not be

disregarded or ignored. To resolve the conflict between the Seventh Circuit decision below and the prior decisions of this Court, and to resolve the conflict between the Circuits, the instant petition for writ of certiorari should be granted.

Respectfully submitted,

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